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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-3411

TULIA FEEDLOT, INC., *Petitioner,*

v.

UNITED STATES OF AMERICA, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE FIFTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit in this case.

OPINION BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at — F. 2d — and is reprinted in Appendix, *infra,* pp. 1a-11a.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit was entered on June 2, 1975. (p. 1a*) The jurisdiction of this court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether fees Petitioner paid to its shareholders for guaranteeing its line of credit are deductible as ordinary and necessary business expenses that are reasonable in amount.

STATUTE INVOLVED

The statute involved is 26 U.S.C. § 162(a) of the Internal Revenue Code of 1954. (p. 20a).

STATEMENT OF THE CASE

Petitioner, Tulia Feedlot, Inc., brought this action for refund of Federal Income Taxes for the taxable year ended August 31, 1970.

Petitioner is a Texas corporation formed in 1962 for the purpose of feeding customers' cattle. The feeding of customers' cattle is not an unduly hazardous business in itself. It is the owners of the cattle who run substantial risk of loss due to declines in the market price of beef. (p. 15a).

Petitioner's feedlot capacity increased from 5,000 head of cattle in 1962 to 28,000 head of cattle in 1970. At various times since its inception, Petitioner, not having sufficient cattle in its pens to operate economically, purchased and fed cattle for itself. The pur-

* References to "a" are to the Appendix, *infra*.

chase of cattle and feed for such cattle required large amounts of cash. The usual method of financing the purchase of cattle is to put approximately thirty (30%) percent down and borrow the other seventy (70%) percent plus $100 per head for cost of feed. (pp. 12a and 13a).

The lending institutions would not make the loans unless they were secured not only by mortgages on the cattle and feed but also by the personal guarantees of the Petitioner's shareholders. For all practical purposes herein the Petitioner had twelve equal shareholders and each shareholder was a director. The guarantees given by Petitioner's shareholders prior to 1970 were $5,000 each in 1964, $8,000 each in 1965, and $45,000 each in 1968. In 1970 the guarantees were increased from $91,000 each in January, to secure a $1.1 million loan, to $125,000 each in March to secure a $1.5 million loan, to $150,000 each in July to secure a $1.8 million loan. (pp. 13a and 14a).

In 1968, Petitioner mortgaged its real and personal property to an insurance company for $350,000 loan. The insurance company required the shareholders to guarantee the loan pro rata. At the beginning and end of the fiscal year ending August 31, 1970 such loan balance was $340,000 and $320,000 respectively. (p. 14a).

On July 14, 1970, Petitioner's directors agreed to compensate themselves as shareholder-guarantors for lending their credit to Petitioner. It was decided that three (3%) percent of the $150,000 guaranty was to be paid to each shareholder for use of his credit. Accordingly, $4,500 was paid to each of twelve shareholder-

guarantors for a total of $54,000, which amount was deducted as an expense of doing business in the fiscal year ending in 1970. (pp. 13a-16a).

The Government disallowed the $54,000 deduction and assessed the resulting tax. Petitioner paid the assessment, filed a claim for refund which was disallowed, and timely brought suit for refund. (p. 13a).

In the subsequent trial of the case, the United States District Court found that the guarantor's fees paid by Petitioner to its shareholders were ordinary, necessary and reasonable business expenses. (pp. 12a-18a).

The Fifth Circuit reversed the District Court in a decision entered June 2, 1975, on the grounds that there was no evidence showing it was ordinary or necessary for cattle feedlots to charge fees for guarantees or that the fees paid were reasonable. (pp. 1a-11a).

REASON FOR GRANTING THE WRIT

In determining that the Petitioner failed to prove the deductions taken for fees paid to guarantors of its line of credit were ordinary, necessary and reasonable, the Court of Appeals for the Fifth Circuit made interpretations of "ordinary and necessary" and "reasonableness" that are in conflict with the decisions of this Court.

The undisputed facts show that there was a need for Petitioner to feed its own cattle in order to operate economically; that the purchase and feeding of its own cattle did produce large net gains overall; that Petitioner had to borrow large amounts of money to purchase and feed its own cattle; that the financial institutions required Petitioner's shareholders to personally guarantee the loans; that it was customary for financial institutions to require shareholders in the feedlot business to guarantee loans; that the financial

institutions would not have made the loans without the guarantees; that without the loans the Petitioner could not have successfully operated its business; that the ownership of cattle involved substantial risk of loss; that the guarantees of Petitioner's line of credit adversely affected the guarantors' personal credit and subjected them to substantial risk; that the shareholders over a period of years prior to the tax year guaranteed smaller loans without requirement of a fee but as the amount of the guarantee doubled and tripled in the tax year (in comparison with the largest amount guaranteed in prior years) the shareholders insisted on being compensated for such guarantees; and that the Petitioner's directors after much discussion concerning the shareholders' risk, the nature of Petitioner's operations, the prevailing interest rates and seeking outside advice to determine what a "proper guarantor's fee" would be, decided to pay 3% of the amount guaranteed as a guarantor's fee.

The Trial Court found upon the facts presented at the trial, that the guarantor's fees paid were deductible as ordinary and necessary expenses and were reasonable in amount. (pp. 12a-18a).

The Fifth Circuit reversed on the ground that the District Court's decision was clearly erroneous because Petitioner failed to prove the guarantors' fees were ordinary, necessary and reasonable in amount. (pp. 1a-11a).

Specifically, the crucial findings of the Fifth Circuit are as follows (pp. 8a-9a):

1. No evidence was presented to show that it was customary for a cattle feedlot's shareholders to charge a fee for their guarantees.

2. No evidence was presented to show what fees, given the risks involved, would be reasonable.

3. No evidence was presented as to the possibility and likely cost of obtaining these guarantees in an arm's length transaction in the market.

The crux of meeting the burden of proof required by the Fifth Circuit is that there be such proof in the first place. Insofar as all parties concerned with Petitioner's case knew, the fees paid Petitioner's shareholder-guarantors were the first ever to be paid in the cattle feedlot busines. There is no market place in West Texas, or anywhere else insofar as Petitioner knows, to obtain guarantees at arm's length for a closely held corporation in the risky[1] cattle feedlot business.

The precise issue of whether a new type of expense in a given industry is deductible has not been directly decided by this Court. Such issue presents an important question of federal law which has not been, but should be, settled by this Court.

In *Commissioner* v. *Tellier,* 383 U.S. 687, at 689, this Court held that the "origin and character of claims with respect to which the expense was incurred, . . ." is the basic test of whether the expense was a business expense. Further, the Court stated at 689 ". . . The principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those

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[1] The plight of ranchers and feedlots owning cattle on feed at the present time is common knowledge and the tremendous losses suffered in 1974 and 1975 in such businesses are documented in the Federal Bankruptcy records.

that are in the nature of capital expenditures, . . .". Again, in *Deputy* v. *duPont,* 308 U.S. 488 at 495, this Court held that the term "ordinary" requires that the transaction which gives rise to the expense must be of common or frequent occurrence in the type of business involved. Here the Fifth Circuit acknowledges Petitioner's evidence shows personal guarantees of the shareholders were commonly required in the feedlot business (p. 8a). The Circuit Court's requirement of evidence to show that it was customary for a cattle feedlot's shareholders to charge a fee for their guarantees goes beyond the burden required by this Court in *Commissioner* v. *Tellier, supra,* and *Deputy* v. *duPont, supra.*

Petitioner could not produce such evidence because insofar as it knew, at the time of the payment of the fees and at the time of the trial, it was the only feedlot whose shareholders charged a fee.

No case has been discovered that holds that a new expense resulting from a transaction that is common in a given business is not deductible simply because it had never been charged or deducted before.[2]

In the case of *Welch* v. *Helvering,* 290 U.S. 111 at 113, this Court stated that the fees paid therein "were

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[2] There is a dearth of cases concerning guarantees. The few cases concerning the matter are generally inconclusive and do not deal directly with the question of a new type of expense. See *A.A. & E.B. Jones Co.* v. *Commissioner,* 19 TCM 1561 (1960); *Central Asphalt Paving Co., Inc.* v. *Commissioner,* 37 P-H Tax Ct. Memo ¶ 68,225 (1968); *R. L. Heflin, Inc.* v. *U. S.,* 58 F.2d 482, (Ct. Cl. 1932), cert. den. 287 U.S. 631 (1932); *Long* v. *Commissioner,* 8 B.T.A. 737 (1927); *Monroe Sand & Gravel Co.* v. *Commissioner,* 36 B.T.A. 747 (1937); *Thornton, Davis B.* v. *Commissioner,* 14 P-H Tax Ct. Memo. ¶ 45,011 (1945); *Universal Milking Machine Co.* v. *Commissioner,* 4 B.T.A. 506 (1926).

necessary for the development of petitioner's business, at least, in the sense that they were appropriate and helpful." In this case there is ample evidence in the record that the fees were necessary because the financial institutions would not have lent the money without the guarantees; the shareholders would not have signed the guarantees without the fee; and without the loans, the feedlot business could not have been successfully carried on and developed.

To meet the Fifth Circuit's requirement of "reasonableness" Petitioner would have had to show comparable fees paid by other feedlots to their shareholders-guarantors, and also show the possibility and likely cost of obtaining such guarantees in an arm's length transaction in the market. Petitioner could not produce such evidence simply because insofar as it knew, at the time the fees were paid and at the time of the trial, it was the only feedlot paying guarantor's fees. Likewise, there is no market place in West Texas, or anywhere else, insofar as Petitioner knew, to obtain guarantees at arm's length for a closely held corporation in the risky cattle feedlot business.

The evidence does disclose that for several years prior to 1970 Petitioner's directors had discussed their guarantees in the light of the risk involved, current rates of interest, the nature of the business and the negative effect on their personal borrowing capacity. (pp. 14a-17a). The corporate minutes also reflect that the directors sought outside advice "concerning the proper guarantor's fees". The District Court found that the three (3%) percent fee charged was reasonable under the circumstances.

The Appellate Court erred in requiring a burden of proof that cannot be carried where a new type of expense is deducted. The burden placed on Petitioner by the Fifth Circuit is not required by any pertinent case dealing with the deductibility of business expenses coming within the terms "ordinary, necessary and reasonable" decided by this Court. See *Commissioner* v. *Tellier,* 383 U.S. 687, 16 L.ed 2d 185, 86 S.Ct. 1118 (1966); *Deputy* v. *duPont,* 308 U.S. 488, 84 L.ed. 416, 60 S.Ct. 363 (1940); *Lilly* v. *Commissioner,* 343 U.S. 90, 96 L.ed. 769, 27 S.Ct. 497 (1952); *Welch* v. *Helvering,* 290 U.S. 111, 78 L.ed. 212, 54 S.Ct. 8 (1933).

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

U.S. COURT OF APPEALS, 5TH CIRCUIT,

No. 74-1928, 6/2/75.

TULIA FEEDLOT, INC., *Plaintiff-Appellee*

v.

UNITED STATES OF AMERICA, *Defendant-Appellant.*

Before WISDOM and DYER, Circuit Judges, and KRAFT,* District Judge.

WISDOM, Circuit Judge: Tulia Feedlot, a closely-held Texas business corporation, brought this tax refund suit to recover income taxes and interest totalling $23,798.81, which it paid under protest when the Commissioner of Internal Revenue disallowed its deduction of $54,000 for alleged guarantors' fees that it had paid, pro rata, to its director-shareholders during its tax year ending August 31, 1970. The question this case presents is whether the taxpayer may deduct as ordinary and necessary business expenses amounts paid its shareholders ostensibly as guarantors' fees. The district court, sitting without a jury, found that the amounts paid were ordinary and necessary business expenses under Int. Rev. Code of 1954, § 162(a),[1] and that they were reasonable in amount. We reverse.

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* Senior District Judge of the Eastern District of Pennsylvania, sitting by designation.

[1] Section 162(a) provides that:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant

I. Tulia Feedlot, the plaintiff-appellee, was organized in 1962 for the purpose of conducting a cattle feedlot in Tulia, Texas. The feedlot grew rapidly from an initial capacity of 5,000 head in 1962 to a capacity of 28,000 head in 1970. Although the corporation had both profitable and unprofitable years during that period, it began the tax year in question with retained earnings of $318,395.27. The corporation declared no dividends until 1972, but it customarily paid a director's fee, in the amount of $2,400 per year, to its directors, who are virtually the only shareholders of the corporation.

During the tax year in dispute, the stock of the corporation was principally, owned by thirteen individuals. Eleven of these thirteen shareholders held equal amounts of the stock, 280 shares. Two other shareholders, a father and his son, each owned one-half of the number of shares owned by the other eleven shareholders, or 140 shares each. In addition to these 3,360 shares, the corporation also had outstanding 22 shares of stock that were owned by employees of the corporation. At least some of the director-shareholders, including the President and Chairman of the Board, are also customers of the feedlot and use its facilities to feed cattle which they own individually or in partnership with others.

Tulia's business has two distinct aspects. Principally, it feeds cattle owned by its customers. When insufficient business is generated by its regular customers, however, Tulia must purchase cattle on its own account to keep the pens full and thereby minimize the feedlot's losses. This second aspect of Tulia's business requires large amounts

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under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

of credit in order to purchase cattle and feed in anticipation of future sale. Financial institutions generally require that the feedlot pay 30 percent of the purchase price of the cattle. They may also require that the loans be secured by mortgages on the feedlot's cattle, feed, and real estate, and that personal guaranties be given by the feedlot's shareholders.

Since 1964, Tulia's principal shareholders have routinely guarantied loans to the corporation in proportion to their stock holdings. In 1964, each shareholder guarantied a pro rata share amounting to $5,000. This amount gradually increased over the following years so that, on January 20, 1970, each shareholder guarantied $91,000. On March 10, 1970, the amount was increased to $125,000. On July 28, 1970, each shareholder increased his guaranty to $150,000. Until July 1970, the guaranties were routinely made without any compensation to the shareholders. At a regular meeting of the board of directors on July 14, 1970, however, the board voted to increase the amount of the guaranty from $125,000 to $150,000, and to pay to each of the shareholder-guarantors an annual fee equal to 3 perment of the amount guarantied by him. Because the corporation operated on an accrual method of accounting, it paid to each shareholder the sum of $4,500 for the fiscal year that ended August 31, 1970. This fee, of course, represents 3 percent of the loan guaranty of July 28, 1970, whereas the amounts actually guarantied by the shareholders during the first eleven months of the fiscal year were considerably less. As a result of these calculations, Tulia paid a total of $54,000 in guarantors' fees for the tax year in question. Interest payments during the same period amounted to $87,991.07.

Although Tulia did not declare a dividend until 1972, the possibility of a dividend had been discussed every year. Evidence adduced at trial demonstrates that some of Tulia's principal shareholders, dissatisfied with the $2,400 annual directors' fees, were impatient with the corpora-

tion's dividend policy and wished to have a more substantial return on their investments. The lack of any evidence to show how the 3 percent figure was determined is particularly significant in this light. That figure was simply the lowest amount that the dissatisfied, pro-dividend directors would agree to accept. It did not, in any way, reflect a rational calculation of the risks involved in the guaranties. Indeed, at least two of the guarantors made guaranties in excess of their respective net worths. Moreover, in 1972, when the corporation declared its first dividend, the director-guarantors increased the rate of return on their guaranties from 3 percent to 6 percent.

As a result of deducting the full $54,000 paid in guarantors' fees from its income in the tax year in question, the corporation had a net loss of $6,309.07. It paid no dividend. At the same time, each of the corporation's principal shareholders received income from the corporation in the nature of a $2,400 director's fee and a $4,500 guarantor's fee. In these circumstances, we think that the $4,500 guarantor's fee was a distribution of property made by a corporation to its shareholders under 26 U. S. C. § 316,[2] and not an

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[2] Section 316 provides that:

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

ordinary and necessary business expense within the meaning of 26 U. S. C. § 162(a). See *Giles Industries, Inc. v. United States,* Ct. Cl. 1974, [74-1 USTC ¶ 9370] 496 F. 2d 556, 563.

II. In order for payments to qualify as ordinary and necessary business expenses under Int. Rev. Code of 1954, § 162(a), they must be appropriate, helpful, and of a common or frequent occurrence in the type of business carried on by the taxpayer. *Lilly v. Commissioner of Internal Revenue,* 1952, [52-1 USTC § 9231] 343 U. S. 90, 72 S. Ct. 497, 96 L. Ed. 769; *Deputy v. Du Pont,* 1940, [40-1 USTC ¶ 9161] 308 U. S. 488, 60 S. Ct. 363, 84 L. Ed. 416; *Welch v. Helvering* [3 USTC ¶ 1164], 1933, 290 U. S. 111, 54 S. Ct. 8, 78 L. Ed. 212. The payments must be ordinary, not in the sense that they are habitually or normally made by a single taxpayer, but in the sense that they are of a known type and commonly made, in some circumstances, by persons in the type of business carried on by the taxpayer. The expenses of a lawsuit to safeguard a taxpayer's business, for instance, may be "unique in the life of the individual affected, but not in the life of the group, the community of which he is a part". *Welch v. Helvering* [3 USTC ¶ 1164], 1933, 290 U. S. 111, 114, 54 S. Ct. 8, 9, 78 L. Ed. 212. The payments must also be ordinary in the sense that they represent expenses that are currently deductible, and not capital expenditures which, if deductible at all, must be amortized over the useful life of the asset. *Commissioner of Internal Revenue v. Tellier,* 1966, [66-1 USTC ¶ 9319] 383 U. S. 687, 689-90, 86 S. Ct. 1118, 16 L. Ed. 2d 185. They must be reasonable in amount. *Limericks, Inc. v. Commissioner of Internal Revenue,* 5 Cir. 1948, [48-1 USTC ¶ 9146] 165 F. 2d 483.

Expenses must be necessary in the sense that they are, at least, appropriate and helpful for the development of the taxpayer's business. *Commissioner of Internal Revenue v. Tellier,* 1966, [66-1 USTC ¶ 9319] 383 U. S. 687, 689, 86

S. Ct. 1118, 16 L. Ed. 2d 185. Section 162(a) does not require that expenses be necessary in a philosphoic or logical sense. As one commentator has suggested, a reading of Section 162(a) based on the logical meaning of "necessary" would "place the courts and the Commissioner in the position of business efficiency experts reviewing the commercial decisions of the taxpayer, a function which they are ill-fitted to perform." Comment, Business Expenses, Disallowance And Public Policy: Some Problems of Sanctioning With The Internal Revenue Code, 72 Yale L. J. 108, 113, n. 20 (1962). Because courts are reluctant to review commercial decisions made by a taxpayer, they have generally looked to the actual practices of businessmen to determine the standard. In determining whether expenses are ordinary and necessary under Section 162, the test is whether a hardheaded businessman, under the circumstances, would have incurred the expense. *Cole v. Commissioner of Internal Revenue,* 2 Cir. 1973, 481 F. 2d 872, 876. This rule is, of course, subject to numerous limitations. First, it is only the business practices of a hard-headed businessman, and not his tax avoidance schemes, that are subject to judicial deference. Second, the practices of an entire trade or profession may be infirm from the standpoint of the administration of the revenue laws. Third, special relationships between the contracting parties may, as here, limit the utility of the hard-headed businessman principle.

The law presumes, for instance, that corporate officers make expenditures of corporate funds only when they consider them to be in the interest of the corporation and its shareholders. *Armour & Company v. Wantock,* 1944, 323 U. S. 126, 130-31, 65 S. Ct. 165, 89 L. Ed. 118. Transactions between related taxpayers or between a close corporation and its principals, who may have a multi-dimensional relationship with the corporation, must be subject to close scrutiny. *United States v. Rage,* 1942, [42-1 USTC ¶ 9186] 314 U. S. 513, 62 S. Ct. 374, 86 L. Ed. 383. In these circum-

stances, it is the nature and origin of a transaction, rather than its form, that must be accorded controlling weight. *Interstate Transit Lines v. Commissioner of Internal Revenue*, 1943, [43-1 USTC ¶ 9486] 319 U. S. 590, 63 S. Ct. 1279, 87 L. Ed. 1607.

The Commissioner's disallowance of a taxpayer's deduction for payments claimed as ordinary and necessary business expenses carries a presumption of correctness. The taxpayer must meet the burden of proving that the Commissioner's determination is wrong. *Welch* v. *Helvering*, 1933, [3 USTC ¶ 1164] 290 U .S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212. Cf. 4A Mertens, Law of Federal Income Taxation § 25.03 (1972). The taxpayer must not only prove that the Commissioner was wrong, but he also has the burden of establishing the facts from which an exact determination of the proper deduction may be made. *Lenox Clothes Shops v. Commissioner of Internal Revenue*, 6 Cir. 1943, [43-2 USTC ¶ 9665] 139 F. 2d 56.

Transactions between related taxpayers are subject to special scrutiny. See *Dillin v. United States*, 5 Cir. 1970, [70-2 USTC ¶ 9647] 433 F. 2d 1097. In determining the true character of a transaction between a close corporation and its principals, the expressed intent of the corporation is entitled to less weight than is the intent of a publicly-held corporation in similar circumstances. Where, for example, corporate directors, who were also the sole shareholders and the creators of a liability, predictably placed in the corporate minutes statements to the effect that a settlement of the liability by the corporation was essential to its continued success, we held that judicial skepticism was both necessary and appropriate. *United States v. Smith*, 5 Cir. 1969, [69-2 USTC ¶ 9726] 418 F. 2d 589, 593-94. As Judge Simpson noted in *Smith*, "[t]he separate legal identity of these corporations should not obscure the fact that they are operated by their shareholders in a manner thought best calculated to serve the latter's interests. What

is deemed best for the shareholders is deemed best for the corporation, and vice versa." *Id.*, at 594. In the analogous area of shareholder-employee compensation, we have held that a deduction claimed for compensation paid to shareholder-employees will not be denied *merely* because paymets are made proportionately to shareholdings, when other evidence persuasively establishes the reasonableness of such compensation solely on the basis of employment-related criteria. *United States v. Safety Engineering & Supply Co., Inc.*, 5 Cir. 1967, [67-1 USTC ¶ 9331] 374 F. 2d 885. The burden in such cases is, of course, substantial.

Tulia introduced evidence to show that the Bank of Tulia, one of the corporation's pre-1970 credit sources, would not have lent it the money it needed without the personal guaranties of the corporation's shareholders. It also introduced evidence to show that such guaranties were commonly required of closely-held corporations in the cattle feedlot business. No evidence was presented, however, to show that it is customary for a cattle feedlot's shareholders to charge a fee for their guaranties. Nor was any evidence presented to show what fees, given the risks involved, would be reasonable in the circumstances here. The corporation now argues that "it is evident from the decided cases that guarantor's fees are *not unknown* in other businesses." As Justice Douglas noted in *Deputy v. Du Pont*, 1940, [40-1 USTC ¶ 9161] 308 U. S. 488, 495, 60 S. Ct. 363, 367, 84 L. Ed. 416, "the fact that a particular expense would be an ordinary or common one in the course of one business and so deductible . . . does not necessarily make it such in connection with another [one]." The taxpayer's failure to meet the burden of proof is compounded here by the absence of any readily ascertainable market price for guaranties for corporations of its type and size. In August 1970, it had paid-in capital of $325,682.57, capital surplus of $89,841.75, and outstanding loans of $1,800,000. Tulia presented no evidence as to the possibility and likely cost of

obtaining these guaranties in an arm's length transaction in the market.

The presence of evidence demonstrating that it is customary for businesses of Tulia Feedlot's size, type, and financial status to pay a 3 percent guaranty to their shareholder-director-guarantors would not, of course, be dispositive. A whole segment of the business community may profit from this method of paying dividends to their corporate principals without the burdensome necessity of declaring a corporate dividend that is twice liable to federal income taxation. We think that the absence of such evidence, however, is dispositive. In the absence of such evidence, the district court could not properly find that the guaranty was an ordinary and necessary business expense because it could not be sufficiently informed as to the economic realities of the transaction.

Although this Court has not previously considered the precise issues presented here, the Tax Court has done so in two similar cases. In *Universal Milking Machine Co. v. Commissioner,* 1926, [CCH Dec. 1554] 4 B. T. A. 506, the Tax Court disallowed a taxpayer's deductions for amounts that it paid to shareholders who had jointly and severally guaranteed its loans. The Court found that the fees charged were exorbitant and that the shareholders incurred no real risk. It did not reach the issue whether a reasonable fee paid to such shareholders for guarantees that involved a genuine risk would have qualified as an ordinary and necessary business expense.

In *A. A. & E. B. Jones v. Commissioner,* 1960, [CCH Dec. 24,593(M)] 19 T. C. M. 1561, the Tax Court allowed a corporation's deduction of guarantor's fees paid to two shareholders as an ordinary and necessary business expense. Even assuming that the legal standards applied by the Tax Court in *A. A. & E. B. Jones* are correct, we think that that case is distinguishable. In *A. A. & E. B. Jones,*

the Court found that the guaranties obtained from the shareholders could have been obtained elsewhere and that the fees for those guaranties were reasonable in terms of those customarily charged in the market under similar circumstances. "The petitioner called a number of witnesses who testified that such payments were usual and that they knew of comparable payments having been made under somewhat similar circumstances." *See J. E. Craig Finance Co., Inc. v. United States,* W. D. S. C. (1962), [62-1 USTC ¶ 9275] 200 F. Supp. 554; *Builders Steel Co. v. Commissioner of Internal Revenue,* 8 Cir. 1952, [52-1 USTC ¶ 9360] 197 F. 2d 263. *Cf Pacific Grains, Inc. v. Commissioner of Internal Revenue,* 9 Cir. 1968, [68-2 USTC ¶ 9536] 399 F. 2d 603.

Unlike the taxpayer in *A. A. & E. B. Jones,* Tulia Feedlot presented no evidence in the district court to show that the guarantors' fees paid to its director-shareholders were customary or reasonable in amount. The scope of our review is limited here by the "clearly erroneous" principle of F. R. Civ. P. 52(a). A finding is clearly erroneous within the meaning of F. R. Civ. P. 52(a) when, although there is evidence to support a district court's finding, the appellate court, after a review of all the evidence, is left with the definite and firm conviction that a mistake has been made. *United States v. Smith,* 5 Cir. 1969, [69-2 USTC ¶ 9726] 418 F. 2d 589, 594; *Pennington v. Colonial Pipeline Co.,* 5 Cir. 1968, 387 F. 2d 903. The district court found that the guarantor's fees paid by Tulia Feedlot to its director-shareholders were ordinary and necessary business expenses that were also reasonable in amount. In light of Tulia's failure to present evidence, and thus meet its burden of proof, on elements essential to that determination, we think that the district court's findings were clearly erroneous. The Commissioner determined that the payments were a distribution of property to shareholders under Int. Rev. Code § 316, and the corporation failed to rebut the presumption of correctness accorded the Commissioner's determination.

Finally, Tulia contends that the government has shifted its theory on appeal and now argues for reversal on the ground of the corporation's thin capitalization. Although the government may have put greater emphasis on the thin capitalization argument on appeal, we do not think that such greater emphasis is essential to our reversal to the district court's decision. We hold only that the taxpayer corporation failed to sustain its burden of proof.

The judgmet of the district court is reversed.

APPENDIX B

UNITED STATES DISTRICT COURT,
N. D. TEXAS,
LUBBOCK DIVISION.

Civ. A. No. 5-1119.

TULIA FEEDLOT, INC., *Plaintiff*,

v.

UNITED STATES OF AMERICA, *Defendant*.

Nov. 30, 1973.

* * * * * * * * * * *

Memorandum Opinion

WOODWARD, District Judge.

The above case came on to be tried before the court, without a jury, on the 31st day of October, 1973, with all parties being present and being represented by counsel in open court. After hearing and considering the evidence and argument of counsel and the respective briefs filed by the parties, the court files this Memorandum Opinion which shall constitute the court's Findings of Fact and Conclusions of Law.

The plaintiff is a Texas corporation engaged in the business of farming, cattle feeding, and the custom feeding of cattle for its customers and has been so engaged each and every year since about the year 1962. The business of the corporation has increased from a capacity of feeding about 5,000 head at its inception to a capacity of about 28,000 head at the present time. The plaintiff, in addition to custom feeding for its customers, feeds its own cattle and its farming operations produces feed for cattle in the feed yards and for grazing. The corporation lost money in the first two years of its operation and lost money again in 1968, 1970, and 1971, but made substantial profits in the other years.

Normally these operations are financed by financial institutions which require a cash payment from the borrower of approximately 30% of the cost of the cattle and the financial institution then loans the money for the balance of the purchase price of the cattle and for the necessary cost of feed, which amounts to about $100 per head. This business necessarily requires large sums of money and credit, especially with respect to the financing by the plaintiff of its own cattle feeding operations.

From the year 1966 forward there were eleven directors and principal stockholders of the corporation who owned all of the 3,400 outstanding shares of stock of the corporation, except about 22 shares owned by employees as minority stockholders. One of the directors, a Mr. Adams, shared his ownership of the stock with his son and in 1970 and subsequent years the number of principal stockholders has been increased by one or two but at all times critical to the determination of this case, the eleven referred to have owned practically all of the stock.

The plaintiff corporation is on an accrual basis for federal income tax purposes and has its fiscal year ending August 31st. The income tax return on Form 1120 was filed for this corporation for the fiscal year ending August 31, 1970 and in the return it was shown that the corporation sustained a loss of $6,309.07 and that there was no income tax liability. An audit of this return was made by the Commissioner of Internal Revenue Service who asserted a deficiency in the amount of $23,798.71 and the plaintiff paid this assessment on April 6, 1972. On May 29, 1972, plaintiff filed a claim for refund which was disallowed by the Commissioner on September 29, 1972, and this action is brought by the plaintiff to recover the assessment so paid. Accordingly, this court has jurisdiction pursuant to 28 U.S.C. § 1346(a)(1).

The deficiency was assessed because the Commissioner disallowed as a deductible expense of the business the sum

of $54,000 which had been paid to the principal stockholders and directors during this fiscal year. Specifically the directors had signed an instrument of guaranty wherein they guaranteed to the Plainview Production Credit Association the payment of any indebtedness owing by Tulia Feedlot, Inc. to that association. Each person's liability was limited to $150,000, with the exception that Mr. Adams and his son guaranteed $75,000 each. The amount of the fee paid, and taken as a business expense by the corporation, was 3% of the amount of the guarantee while the amount of the guarantee of each such stockholder-director was proportionate to his percentage of ownership of the stock of the corporation. The testimony in the suit and the minutes of the board of directors indicate that this fee was to be paid annually.

These directors and stockholders had on many occasions previously executed guaranty agreements on loans made to Tulia Feedlot, Inc., and in each instance their guarantee was proportionate to their ownership of the shares of the stock in the corporation. These guarantees were: $5,000 each in 1964 to the First National Bank of Tulia, $8,000 in 1964-1965 to the First National Bank of Tulia, $45,000 in 1967 or 1968 to the First National Bank of Tulia, $91,000 on January 20, 1970 to secure a $1.1 million dollar loan from the First National Bank of Tulia, $125,000 to secure a $1.5 million dollar loan to Plainview Production Credit Association on March 10, 1970, and $150,000 guarantee each to secure a loan from said association in the amount of $1.8 million dollars on July 28, 1970. In addition, John Hancock Mutual Life Insurance Company made a loan of $350,000 in 1968 to the corporation, the payment of which was similarly guaranteed by these directors-stockholders.

Each of these instruments of guaranty was executed by the stockholder-directors without any fee, payment, or compensation to them except for the 3% fee paid to them by the corporation for their guaranty of the $1.8 million dollar

loan. However, there had been many previous discussions among the members of the board of directors that such fees should be paid and the board of directors considered the authorization of such fees for several of the guaranties above listed but it was not until the $1.8 million dollar loan was obtained that the fee was actually authorized and paid.

The stockholder-directors were not required to offer collateral to support their guarantee but the corporation secured the loan with various mortgages and other security instruments covering its cattle and certain stored feed. The John Hancock loan was secured by a mortgage on real estate.

An officer of the First National Bank of Tulia testified that although the corporation was considered to be in good financial shape that the bank would not have made any of the loans involved unless the guarantees were received by the bank insuring individual liability on the part of the stockholder-directors. Similarly an officer of the Plainview Production Credit Association stated that the loans made by the association to the plaintiff would not have been made without these guarantees.

There is evidence that although this business is not considered to be "risky," that the "ups and downs" of the cattle market did create a condition that made it necessary, from a lender's point of view, to secure these loans rather than to depend upon the assets of the corporation alone to repay the indebtedness.

Although there is evidence indicating that the corporation could have stayed in business without getting its line of credit from the association extended upward from $1.5 million dollars to $1.8 million dollars, it is obvious that this type of business could not be successfully carried on and enlarged by the plaintiff corporation without adequate and heavy financing.

The shareholder-directors who testified stated that, although they had executed similar guarantees in the past, they would not have signed the $150,000 guarantee unless they received some remuneration. By the execution of these guarantees the stockholders-directors provided a valuable and necessary service to the corporation and at the same time decreased their individual borrowing capacities because this guarantee would be listed on their financial statements as a liability, thereby reducing their net worth.

Although there is no direct evidence as to what was the usual and customary fee for guaranteeing such loans, the board of directors of the plaintiff corporation had discussed this question on many occasions and in doing so took into consideration the risk involved, the nature of the operations of the corporation, the fact that their individual lines of credit would be restricted and the current rate of interest charged by the banks and associations for these loans. It was finally agreed that the 3% fee would be charged, as it was the lowest figure upon which all the directors could agree.

The Government contends that the payment of these fees to the stockholder-directors was a distribution of income in the nature of a dividend rather than a business expense because the amount of the fees was proportionate to their percentage of ownership of the stock of the corporation. Plaintiff contends that the payment of the fees was necessary, that it was done in the ordinary course of business, that the amount of the fee was reasonable and, therefore, that the deduction should be allowed.

[1, 2] The payment of amounts to the stockholders of the corporation in proportion to their ownership of the stock of the corporation constitutes prima facie evidence that the payments were dividends. But the plaintiff contends that the evidence in this case rebuts this prima facie presumption of a dividend. The court is in agreement with the plaintiff.

First of all, the fee of 3% of the amount guaranteed, under all of the facts and circumstances of this case, was reasonable. It was reasonably related to the then current interest rates and the amount of risk involved. Further, it was reasonable in light of the adverse effects on the borrowing capacity of each of the guarantors. Significantly, there is no evidence in the record that the directors of the corporation determined the amount of the fee after consideration of its effect on the amount of income tax that would have to be paid for the year 1970. To the contrary it appears that the fee was charged and the amount thereof was determined on considerations other than the resulting income tax liability to Tulia Feedlot, Inc.

Secondly the payment of such a fee was necessary. Without the loan the business could not have been successfully operated and the loans would not have been made in this case unless they were guaranteed by the directors. Further, the testimony indicates that the directors would not have guaranteed the loan which is in question in this case without the payment of a fee. Therefore, in order to operate and expand its business in an efficient manner, the plaintiff was required to pay the fee in this case.

[3] It therefore appears that the plaintiff could properly deduct deduct a fee made to a guarantor of a loan it obtained from a financial institution under these circumstances. But the question has been raised as to what portion of the fee should be allowed as a deduction for the year 1970. It should be noted that the guaranties are each dated July 28, 1970 and call for the guarantee of the payment of the indebtedness of Tulia Feedlot, Inc. to the Plainview Production Credit Association to the extent of $150,000 and that it was agreed by the directors of the plaintiff corporation that this would be an annual fee. These payments were made about one month before the termination of the corporate fiscal year. As the corporation was on an accrual basis for the purposes of income tax

computations, the deduction was allowable in the taxable year in which all the events fixing liability occurred. 26 C.F.R. § 1.461-1(a)(2). The Certified Public Accountant who supervises plaintiff's records testified that, under the above test, the guarantor's fee accrued in the fiscal year ending August 31, 1970 and that the fee was thus deductible in that fiscal year. The fee was authorized and paid during the taxable year ending August 31, 1970, thus all the events determining the fact and amount of liability occurred during that year. This court is convinced that, under the above Internal Reveue Service Regulation, the $54,000 in fees was fully deductible in the taxable year ending August 31, 1970.

Accordingly, it is ordered that a proposed judgment will be prepared by the attorney for the plaintiff and submitted to the attorney for the Government for approval as to form. Interest is allowed in accordance with law and all costs are taxes against the defendant.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
LUBBOCK DIVISION

CIVIL ACTION NO. 5-1119

TULIA FEEDLOT, INC., *Plaintiff*,

v.

UNITED STATES OF AMERICA, *Defendant*.

Order

The court has received the Supplemental Memorandum of Law for the defendant and has examined same.

The defendant suggests in this memorandum that the director-shareholders could, by raising the amount of the fee charged for the guarantee, eliminate all profits of the corporation and that the director-shareholders could siphon off all the profits in this manner. To support this position the defendant cites the fact that the fee has been raised from three percent to six percent for the year 1973.

The court emphasizes that its Memorandum Opinion of November 29, 1973 is limited solely to the three percent fee which was paid and deducted by the corporation from its income tax for the fiscal year 1970 and that such Memorandum Opinion does not and is not to be construed as ruling on the reasonableness of any other fee for any other taxable year of the plaintiff corporation.

Accordingly the attorney for the plaintiff will, as ordered by this court on November 29, 1973, immediately prepare and submit to the attorney for the government for approval as to form a judgment in accordance with the court's Memorandum Opinion and Order of November 29, 1973.

The Clerk will furnish a copy hereof to each attorney.

ENTERED this 2nd day of January A.D. 1974.

/s/ HALBERT O. WOODWARD
Halbert O. Woodward
United States District Judge

APPENDIX C

Section 162(a) of the Internal Revenue Code

§ 162(a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-341

TULIA FEEDLOT, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner seeks review of the decision in this income tax case that fees paid by it to its shareholders were not deductible business expenses under Section 162 of the Internal Revenue Code of 1954. The court of appeals concluded that petitioner failed to present evidence essential to finding that the fees were ordinary and necessary business expenses and were reasonable in amount.

The pertinent facts are as follows: Petitioner is a closely held corporation which operates a cattle feedlot. During 1970, petitioner had 13 principal shareholders, 11 of whom were directors who each owned 280 shares, and two of whom each owned 140 shares (Pet. App. A 1a-2a; Pet. App. B 13a).

Petitioner fed cattle owned by both its customers and itself. Because the purchase of cattle and feed required large amounts of credit, petitioner's principal shareholders have routinely guaranteed its indebtedness. The amount of the indebtedness guaranteed by each principal shareholder was proportionate to his percentage of ownership (Pet. App. A 2a-3a; Pet. App. B 12a-13a).

From 1964 until 1970, the principal shareholders guaranteed petitioner's indebtedness without compensation. Some principal shareholders were dissatisfied, however, because petitioner, which began the 1970 taxable year with retained earnings of $318,395.27, had never declared a dividend. As a result, in July, 1970, just prior to the end of petitioner's taxable year, petitioner's board of directors voted to increase the amount of each shareholder's guaranty to $150,000, and to pay to each shareholder-guarantor an annual fee equal to three percent of the amount he had guaranteed. For the taxable year 1970 petitioner paid $54,000 in guarantors' fees to its principal shareholders (Pet. App. A 2a-4a).

Petitioner claimed the $54,000 as a deduction and reported a loss of $6,309.07 on its 1970 income tax return. On audit, the Commissioner of Internal Reve-

nue determined that the fees were in fact a distribution by petitioner of a nondeductible dividend to its shareholders (Pet. App. A 4a, 10a; Pet. App. B 13a).

In this refund suit, the district court upheld petitioner's claimed deduction, concluding that the fees were ordinary and necessary business expenses and were reasonable in amount (Pet. App. A 1a; Pet. App. B 16a-18a). The court of appeals reversed. It concluded that the findings of the district court were clearly erroneous because petitioner failed to present evidence that the guarantee payments were ordinary and necessary and that they were reasonable in amount (Pet. App. A 8a-11a).

The court of appeals correctly held that petitioner presented no evidence to show that it was customary for a cattle feedlot's shareholders to charge a fee for their guaranties, or to show what fees, given the risks involved, would be reasonable in the circumstances of this case, and that the absence of such evidence was fatal to petitioner's claim.[1] As that court stated, "In the absence of such evidence, the

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[1] The court of appeals further observed, however, that even the presence of such evidence would not compel judgment for petitioner (Pet. App. A 9a):

> The presence of evidence demonstrating that it is customary for businesses of Tulia Feedlot's size, type, and financial status to pay a 3 percent guaranty to their shareholder-director-guarantors would not, of course, be dispositive. A whole segment of the business community may profit from this method of paying dividends to their corporate principals without the burdensome necessity of declaring a corporate dividend that is twice liable to federal income taxation.

district court could not properly find that the guaranty was an ordinary and necessary business expense because it could not be sufficiently informed as to the economic realities of the transaction" (Pet. App. A 8a-9a).[2]

The lack of any evidence to show how the three-percent figure was determined is particularly significant in this case where a closely held corporation had retained earnings in excess of $300,000 and some shareholders were dissatisfied about the lack of dividends. Moreover, the shareholders extended the guaranties in direct proportion to their percentage interests, which is a strong indication that the fees in question were nondeductible dividend distributions. Although the three-percent fee was the lowest amount that the dissatisfied shareholders would accept, it did not reflect an analytical calculation of the risks involved in the guaranties. Indeed, two shareholders actually guaranteed amounts in excess of their respective net worths (Pet. App. A 2a-4a).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

OCTOBER 1975.

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[2] Contrary to petitioner's assertion (Pet. 4), this decision is not in conflict with any decision of this Court. The court of appeals (Pet. App. A 5a-6a) followed the decisions of this Court which construe the phrase "ordinary and necessary" of Section 162.

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